STATE OF MICHIGAN

COURT OF APPEALS

SHR LIMITED PARTNERSHIP,

Plaintiff-Appellee,

v

NORTHERN LAKES PETROLEUM INC. and O.I.L. ENERGY CORPORATION,

Defendants-Appellants.

UNPUBLISHED
September 24, 2002

No. 225484
Charlevoix Circuit Court
LC No. 99-188818-CK

Before: Jansen, P.J., and Smolenski and Wilder, JJ.

PER CURIAM.

Defendants appeal as of right from a grant of summary disposition in favor of plaintiff. We reverse and remand.

On August 26, 1993, plaintiff and defendant Northern Lakes Petroleum, Inc. ("NLP") entered into a three-year lease for plaintiff's mineral interest in 7,242 surface acres located in Charlevoix County. As a bonus for executing the lease, plaintiff was paid $7,915, which was computed at "$5.00 per net mineral acre." The lease contained a two-year renewal clause. In June 1996, in an effort to exercise this option, NLP sent a check to plaintiff in the amount of $7,584.25.

In January 1996, defendant O.I.L. Energy Corporation ("O.I.L.") applied for a drilling permit to drill a well on an eighty-acre unit, a portion of which plaintiff owned an interest. On November 3, 1997, O.I.L. filed a petition for compulsory pooling, which was granted on March 3, 1998. On November 26, 1997, NLP assigned its rights under the lease to O.I.L., reserving to itself an overriding royalty.

On May 7, 1998, O.I.L. began drilling a well in the eighty-acre drilling unit whose acreage included lands in which plaintiff owned mineral rights. In July 1998, O.I.L. notified plaintiff that the well was drilled and shut-in, and submitted a shut-in royalty payment to plaintiff in the amount of $1,517.08. In October 1998, plaintiff returned the payment because it believed the June 1996 "lease extension payment" was insufficient to extend the lease, and, therefore, the lease was not in effect when the well was drilled in May 1998. Plaintiff notified defendants that unless they were willing to "promptly entertain negotiations for a lease more favorable to SHR," plaintiff would file an action to quiet title.

Plaintiff filed this lawsuit in February 1999, and amended its complaint in November 1999. Plaintiff alleged in count I that the June 1996 payment was insufficient to extend the lease because paragraph 17 of the lease was clear and unambiguous, requiring payment of "$5.00 per acre," which according to plaintiff meant $5.00 per surface acre, and, therefore, payment of $36,210 was required to extend the lease. Plaintiff also put forth two alternative theories. In count II, plaintiff alleged that defendants made no good faith efforts to develop the land and therefore asked the trial court to terminate any leasehold interest that may have been assigned by NLP to O.I.L. and later pooled by O.I.L. In count III, plaintiff alleged that defendants failed to develop the property pursuant to the lease terms and, therefore, the lease lapsed.

Plaintiff and defendants filed competing motions for summary disposition. The court granted summary disposition in favor of plaintiff on count I, and, therefore, did not address counts II and III.

Defendants argue that the court erred in focusing on the words "$5.00 per acre" in paragraph 17 of the lease to the exclusion of the lease's other provisions. We agree. The construction of a contract presents a question of law which is reviewed de novo on appeal. *Bandit Enterprises, Inc v Hobbs Int'l, Inc (After Remand)*, 463 Mich 504, 511; 620 NW2d 531 (2001).

Paragraph 17 stated,

> This lease may, at Lessee's option, be extended as to all or part of the lands covered hereby for an additional term of 2 years commencing on the date that the lease would have expired but for the extension. Lessee may exercise its option by paying or tendering to Lessor a bonus of $5.00 per acre for the land then covered by the extended lease, said bonus to be paid or tendered in the same manner as provided in Paragraph numbered 4 hereof with regard to the payment of shut-in royalties.

In interpreting this paragraph, the court concluded that paragraph 17 was not ambiguous and clearly stated that the payment for extension of the lease was to be made at "$5.00 per acre," not "$5.00 per mineral acre." Therefore, the court held that defendants were required to pay plaintiff $36,210 in order to effectuate the lease extension.

The purpose of interpreting a contract is to determine and enforce the intent of the parties. *Old Kent Bank v Sobczak*, 243 Mich App 57, 63; 620 NW2d 663 (2000). In doing so, a court must read the parties' agreement as a whole and attempt to apply the plain language of the agreement. *Id*.

Defendants argue that paragraph 6, a proportional reduction clause, was applicable to paragraph 17. Defendants contend that because paragraph 17 states that the extension payment was to be paid in the same manner as the shut-in royalties, covered in paragraph 4, and paragraph 6 applied to shut-in royalties, therefore, paragraph 6 applied to paragraph 17. However, paragraph 6 only applied to royalties covered in the previous paragraphs. The extension payment was considered a bonus and was covered in paragraph 17, a subsequent provision.

Defendants also argue that "$5.00 per acre" should be read as "$5.00 per net mineral acre" because it is an industry custom that payments in mineral right leases are made on a net mineral basis. Given the evidence presented on this point, we believe that an ambiguity exists as to the meaning of "$5.00 per acre" in paragraph 17. A contract provision is ambiguous if it is susceptible to two or more reasonable interpretations. *D'Avanzo v Wise & Marsac, PC*, 223 Mich App 314, 319; 565 NW2d 915 (1997). Generally, if the contract language is ambiguous, then there exists a question of fact which the factfinder must resolve, and summary disposition is not proper. *Id.* However, we believe that it is unnecessary to resolve this ambiguity given the effect of paragraph 14.

Paragraph 14 stated,

> Lessor does not warrant its title to the leased land. In the event Lessor has a lesser ownership interest than as stated herein, then the royalties and other payments hereunder shall be reduced accordingly, but there shall be no recoupment of the payments.

The lease stated that it covered plaintiff's interest in 7,242 acres. The lease did not specify plaintiff's ownership interest percentage in the land, implying one-hundred percent ownership. However, the parties agree that plaintiff's interest is only fractional.

Our Supreme Court has held that an oil and gas lease should be read "not only according to its words, but in connection with the purpose of its clauses." *JJ Fagan & Co v Burns*, 247 Mich 674, 678; 226 NW 653 (1929); *Michigan Wisconsin Pipeline Co v Michigan Nat'l Bank*, 118 Mich App 74, 81; 324 NW2d 541 (1982). It is not uncommon for an oil and gas lease "to convey the entire fee, in order to make certain that no fractional interest is left outstanding in the lessor." 38 Am Jur 2d, § 93. The lessee is then protected from paying the lessor on a greater interest than the lessor owns by the inclusion of a proportional reduction clause, which provides that if the lessor owns less than the entire fee, payments to the lessor are paid only in the proportion that his interest bears to the entire fee. *Id*.

Paragraph 14 is such a clause. It specifically provided that if plaintiff had a lesser ownership interest than was stated in the lease, then royalties and other payments were to be reduced according to that interest. The extension payment was clearly included as "other payments." Therefore, paragraph 14 provided for the extension payment to be calculated according to plaintiff's actual ownership percentage.

We conclude that, under the circumstances of this case, the extension payment, by operation of paragraph 14, was to be calculated effectively on a net mineral acre basis.[1]

[1] The dissent argues that paragraph 17 is unambiguous and must be enforced as written. The dissent also correctly explains the meaning of paragraph 14. Because both of the parties agree that plaintiff's acreage ownership interest is fractional, under the dissent's analysis, the calculation of the extension payment would be as follows: ($5.00 per acre x 7,242 acres) x plaintiff's actual ownership percentage. Under our analysis, the calculation is: $5.00 per acre x (7,242 acres x plaintiff's actual ownership interest). Therefore, under either calculation the result is the same because paragraph 14 operates to reduce the amount due under paragraph 17. Given that contracts must be read as a whole, we fail to understand why the dissent does not include the

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However, we cannot grant summary disposition in favor of defendants because it is not clear from the record what plaintiff's fractional interest is. Defendants indicate that it should be calculated based on 6,940 acres, but plaintiff asserts that 7,242 acres is correct. Therefore, we remand this case for such a determination. Once plaintiff's fractional interest is determined, the court shall calculate the amount which was required to extend the lease by multiplying plaintiff's fractional interest by $5.00. The court is then to determine if the payment actually submitted by defendants was sufficient to extend the lease. If it was, then summary disposition should be granted in favor of defendants. If it was not, then summary disposition in favor of plaintiff was proper.

If the lease was extended, in the interest of judicial economy, we address the parties' motions for summary disposition in regards to counts II and III. Although not resolved in the lower court's judgment, an issue may be considered by an appellate court if it presents a legal question regarding which the facts necessary for its resolution have been presented. *D'Avanzo, supra* at 325.

A motion for summary disposition under MCR 2.116(C)(10) tests whether there is factual support for a claim. *Spiek v Dep't of Transportation*, 456 Mich 331, 337; 572 NW2d 201 (1998). When deciding a motion for summary disposition, a court must consider the pleadings, affidavits, depositions, admissions and other documentary evidence submitted in the light most favorable to the nonmoving party. *Ritchie-Gamester v City of Berkley*, 461 Mich 73, 76; 597 NW2d 517 (1999).

Count II alleged that O.I.L. acted in bad faith when it filed a declaration for consolidation and pooling on August 11, 1998, because it was not filed for the purpose of developing hydrocarbon production from shallow formations, but rather for mere speculation. Plaintiff contended in its complaint that O.I.L. made no good faith efforts to develop the lands described in the declaratory action.

Lessees have an implied good faith duty to develop the property for the purpose of making a profit and may not merely hold the lease for speculation. *Michigan Wisconsin Pipeline Co, supra* at 83. This good faith duty is satisfied when the lessee does what a reasonably prudent lessee would do acting in regard to the interests of both the lessor and lessee. *Id.* "In determining if an operator acts in a reasonable and prudent manner, a court must give deference to his judgment on decisions concerning the appropriate development of a field." *Id*. To terminate the oil and gas lease, the lessor must prove that a reasonably prudent operator would not have continued to operate, or in this case, would have continued to operate, the field under similar circumstances. *Id*.

Defendants argue that they were relieved of their duty to further develop the land described in the declaratory action when plaintiff filed this lawsuit in February 1999 because it was then economically impossible to develop the land, given that no investor would contribute money because the validity of the lease extension was in question.

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operation of paragraph 14 in its equation.

Plaintiff asserts that this argument has no merit because defendants knew of plaintiff's position well before the declaratory action was filed based on correspondence between the parties. However, we believe that there is a difference between knowing of the *possibility* that plaintiff might challenge the lease extension's validity and facing that certainty by way of a lawsuit.

We cannot say that, as a matter of law, the evidence conclusively establishes bad faith on the part of defendants in filing the declaratory action. Therefore, we hold that there exists a question of fact regarding whether defendants' actions following the declaratory action constituted good faith, and summary disposition would be inappropriate. In the event that the court determines on remand that the original lease was extended, if the factfinder determines that defendants acted in good faith, then defendants still have viable lease rights in the 2,506-acre tract. If the factfinder determines that defendants acted in bad faith, then defendants lease rights in the 2,506-acre tract expired.

Count III alleged that O.I.L.'s pooling rights under paragraph 9 of the lease lapsed because it failed to drill one well for every 160 acres within one year of the declaratory action. Plaintiff contended that O.I.L.'s failure to satisfy paragraph 9 terminated its lease rights. Paragraph 9 of the lease provided in part,

> Lessee is granted the right to pool or unitize the shallow formations in said land, or any part of said land with other lands, to establish units containing not more than approximately 2,560 acres. The exercise of this right shall be effective only of Lessee drills or has drilled, no later than one (1) year after recording a written declaration of the unit, at least one well completed in a shallow formation for each 160 acres of the unit.

Defendants argue that regardless of the application of paragraph 9, their lease rights did not terminate because of the operation of lease paragraphs 2 and 4, which provided that a shut-in well on pooled land was considered a producing well, and the existence of a producing well held the lease open past its expiration. Defendants contend that because the Kosc well was drilled and shut-in on pooled land, the lease did not terminate.

Plaintiff argues that the eighty acres which were pooled in March 1998 was not a valid pooling unit because it was not done in accordance with paragraph 8 of the lease, which provided that the lessee may create a pooling unit by recording a declaration with the register of deeds. Plaintiff asserts that because defendants did not record a declaration with the register of deeds, the eighty-acre pooling unit was invalid, and, therefore, the lease could not be held open by virtue of the Kosc well.

We agree with defendants that plaintiff ignores the effect of paragraph 10 of the lease, which provided,

> All present and future rules, regulations, and orders of any governmental agency pertaining to well spacing, drilling or production units, use of material and equipment, or otherwise, shall be binding on the parties hereto with like effect as though incorporated herein at length, provided, however, that no such rule, regulation, or order shall (a) prevent Lessee from pooling oil and/or gas

development units as provided in Paragraphs numbered 8 and 9 hereof, larger than the well spacing, drilling or production units prescribed or permitted by such rule, regulation or order or (b) require a greater density for shallow formation wells than required by Paragraph numbered 9 above.

The eighty-acre drilling unit was the result of the Michigan Department of Environmental Quality supervisor of wells' order granting O.I.L.'s petition for compulsory pooling. Paragraph 10 specifically provides that governmental agency orders are incorporated into the lease, and, therefore, the supervisor of wells' order, being such an order, was incorporated into the lease. Therefore, we hold that the lease was held open by virtue of the shut-in Kosc well. If the court determines on remand that the original lease was extended, defendants still have viable lease rights in the eighty-acre tract, and summary disposition on count III should be granted in favor of defendants.

Reversed and remanded. We do not retain jurisdiction.

/s/ Michael R. Smolenski
/s/ Kurtis T. Wilder